

David Milford
Civil Aviation Authority
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E14 4HD

28 November 2023

Dear Sir

Response to the Civil Aviation Authority's ("CAA") draft Terms of Reference ("ToR") for the Independent Review of Heathrow Airport Limited's ("HAL") cost allocation methodology for Other Regulated Charges ("ORCs")

Our client: Padox UK OpCp Ltd T/A Hilton Garden Inn London Heathrow Airport

We act for Hilton Garden Inn Heathrow and write to provide comments on the CAA's draft ToR for the above review.

As CAA will know, Padox and other ORC users have been concerned about the lack of transparency over ORC fixed costs for a number of years. HAL has refused to give a detailed breakdown of the fixed costs that our client is asked to pay, citing the CAA decisions on H7 and Q6 as limiting the transparency they consider necessary. Unless this review is able to tackle this lack of transparency, we have doubts as to the efficacy of the review.

Scope of the independent review

In the draft ToR the CAA appears to recognise the need for the independent review to identify and examine both the calculation and allocation of fixed costs, stating that the review will:

"1. Determine whether the costs to which the cost allocation methodology applies have been sufficiently clearly and robustly identified, are appropriate and have been assessed at a reasonable level of detail to support a robust cost allocation methodology..." with the explicit aim of determining "whether the right costs are used in the methodology"; and

"2. Assess HAL's approach to the allocation of costs to each Specified Facility for which it charges ORCs. This will determine whether the right costs are allocated to each Specified Facility"; and

“4. Assess the appropriateness of HAL’s approach to the allocation of fixed costs and “annuities” to each Specified Facility and between airline and non-airline users.”¹

Our client agrees with the scope of the review as outlined on the understanding that the costs which HAL identify as “fixed costs” are to be considered and verified as reasonable by the independent reviewer before they go on to consider the allocation methodology. HAL’s calculations which relate to fixed costs must be made visible to stakeholders and to the CAA in order for there to be a meaningful assessment of their appropriateness and, in turn, the appropriateness of the contingent methodology. For example, there is no explanation of the electricity and water fixed costs, or why the charges appear to vary with respect to costs that are meant to be “fixed”.

HAL must similarly account for annuities if these are to be covered by the review; for example, by detailing the relevant assets (as contained in the asset register and RAB) base, the life of such any assets, depreciation profiles, and discount rates. In addition, there should be transparency over any other costs of a fixed nature.

Despite and contrary to the above, HAL have recently indicated that they do not consider it necessary for the review to examine the calculation of fixed costs at all, only their allocation. During a meeting between HAL and stakeholders on 6 November 2023 and in subsequent correspondence, HAL stated that fixed costs “*have essentially been fixed,*” having been “*determined by the CAA (albeit based upon numbers provided by Heathrow)*” as part of the H7 decision and incorporated at table 8.2 of the decision document.²

Table 8.2 of the H7 document (extracted below) contains figures for the years spanning 2022 to 2026 but gives no detail on how these figures have been calculated. The £18 million of “*non-airline costs*”, which seems to form the basis of HAL’s ORCs calculations, in particular needs to be accounted for.

Table 8.2 CAA ORC H7 forecast

ORC H7 forecast, £ million (2020 prices)	2022	2023	2024	2025	2026	Total
Total Opex (excluding rates)	1,014	1,022	1,057	1,077	1,061	5,229
15.5% of total Opex	157	158	164	167	164	811
Business rates adjusted	1.2	1.1	1.1	1.1	1.1	5.5
Bus and Coach	- 1.3	- 1.2	- 1.2	- 1.3	- 1.2	- 6.3
£18 million transfer of non—airline costs from Airport charge	18	18	18	18	18	90
CAA H7 Final Decision Forecast	175	176	182	185	182	900

In previous correspondence HAL have also referred to the Q6 decision to explain their calculation of fixed costs, specifically Figure G.4 of CAP1151 which dates to 2014 (extracted below).³ Our client considers that this table is too outdated to be relevant to current pricing

¹ Ibid., p. 4

² CAP2524C, p. 66 - [Economic regulation of Heathrow Airport: H7 Final Proposals Section 2: Building Blocks \(caa.co.uk\)](https://www.caa.co.uk/consultations-and-licences/cap2524c)

³ [CAP 1151: Economic regulation at Heathrow from April 2014: Notice granting the licence \(caa.co.uk\)](https://www.caa.co.uk/consultations-and-licences/cap1151), p. 278

models. In any case Figure G.4 also fails to explain the underlying figures behind the forecasts given.

Figure G.4: Forecast revenue from ORCs in Q6 - 4 years 9 months basis

£000's	9 mo. 2014	2015	2016	2017	2018
Check-in desks	3,815	5,103	5,056	4,752	4,602
Baggage systems	93,974	110,403	104,652	107,308	108,532
Services for PRMs	13,154	17,250	16,561	14,846	14,704
Staff car parking	10,802	14,325	14,088	13,783	13,607
Staff ID cards	869	1,128	1,112	1,102	1,091
FEGP	7,832	9,955	9,420	9,041	8,903
PCA	4,271	5,464	5,238	5,148	4,950
Airside licences	712	923	918	918	919
Waste, recycling and refuse collection	2,146	2,984	2,814	2,828	2,852
Taxi feeder park	1,481	1,909	1,902	1,865	1,865
Heating	745	970	966	968	969
Electricity	28,245	36,463	35,894	35,220	34,366
Gas	116	154	151	151	150
Water and sewerage	3,781	4,602	4,447	4,327	4,192
Facilities for bus and coach operators	1,676	2,191	2,159	2,115	2,049
Common IT infrastructure	279	353	340	331	319
HAL contribution to the funding of the AOC	310	404	402	401	401

Source: HAL ABP adjusted to reflect the CAA's opex efficiency and traffic assumptions

HAL has been challenged on the above on multiple occasions and as yet have provided no further information on fixed costs besides the two tables above, in direct contradiction to their own principles of transparency and cost reflectivity.⁴ The end result is that our client and other stakeholders are being asked to pay costs which, in some cases, are many times the market rate without explanation or justification. This is clearly unsatisfactory.

Furthermore, as per your letter to us dated 27 September 2023, we are aware that the CAA has chosen not to undertake *“a detailed “bottom-up” cost investigation or benchmarking exercise....as this was not considered a proportionate response to setting the overall ORCs framework for a five year price control process.”* In your letter you remark that owing to our client's concerns surrounding ORCs, *“we decided that the appropriate way for the CAA to further the interests of consumers was to require HAL to facilitate the one-off independent review.”*

As per our letter dated 23 October 2023, we do not agree that such an investigation would be disproportionate, but in any event it is clear that an independent review will not achieve that aim or be effective if HAL continue in their failure to provide the relevant information. Based on recent conversations it would appear that this is their intention. If the CAA has decided that the independent review is the appropriate mechanism with which to address the issue of fixed costs, it must ensure that the ToR are drafted so as to compel transparency from HAL around fixed costs and ensure that the reasonableness of those costs is

⁴ CAP2591, p. 13

considered independently. If it fails to do this, the CAA will be falling short of its regulatory duties, and in particular its duty to protect the interests of consumers who will ultimately bear the cost of HAL's regime.

HAL's license conditions are also relevant to the issue. Condition 2.4 states that:

"The Licensee shall facilitate and pay for an independent review of the appropriateness of the cost allocation methodology to validate that the cost allocation methodology ensures that the costs of the Specified Facilities are allocated between airlines and non-airline users of the Specified Facilities on a fair and reasonable basis."

It is unclear how the CAA can be assured of the "appropriateness" of HAL's cost allocation methodology without assessment or even disclosure of the underlying cost calculations. Condition C2.5 further requires HAL to disclose:

"to [the CAA] and users of the Specified Facilities statements of the actual costs it has incurred and the revenues it has generated in respect of each of the Specified Facilities for the preceding Regulatory Year in a form, and to a sufficient degree of detail, as set out in the governance arrangements, to enable the CAA and users of the Specified Facilities to be reasonably satisfied that the charges that the Licensee proposes to apply to the Specified Facilities are derived in accordance with the cost allocation methodology."

As explained above HAL have not provided a breakdown of their actual costs "to a sufficient degree of detail" in accordance with this license condition and the CAA should be willing as regulator to enforce this condition. Again, amending the ToR accordingly would be an appropriate means of ensuring transparency on HAL's part and the appropriateness of any consequent methodology.

Other issues

Finally, our client does not consider it appropriate in the circumstances for HAL to appoint the independent reviewer, even with "engagement with the CAA and ORC users."⁵ Given the protracted nature of the discussions around ORCs and stakeholders' concerns around transparency, the CAA should itself ensure that an appropriate person is identified for this role in consultation with all parties.

Conclusion

We therefore ask that the draft ToR be amended. The final ToR should make it clear that the independent review will cover both the calculation and allocation of fixed costs and require the disclosure by HAL of all relevant calculations which have so far fed into their estimation of fixed costs (and in particular the £18 million figure set out in Table 8.2 above).

We remind you of the CAA's wider powers as granted by s. 60 of the Civil Aviation Act 2012 to act concurrently to the Competition and Markets Authority in ensuring that no market feature "prevents, restricts, or distorts competition" in the UK.⁶ The energy costs charged to our client according to HAL's framework, at several times the market rate, patently prevent, restrict, and distort competition in relation to the provision of airport services at Heathrow Airport.

Please also confirm that the CAA will itself ensure that an appropriate reviewer is identified.

⁵ Ibid., p. 1

⁶ s. 60 Civil Aviation Act 2012; in conjunction with s. 131 Enterprise Act 2002.

Yours sincerely

Mills & Reeve LLP

Mills & Reeve LLP
enc

From: [REDACTED] >

Sent: Friday, November 10, 2023 9:32 AM

To: [REDACTED]

Cc: [REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]

Subject: RE: Key themes from the non-airline ORC user protocol meeting

Classification: Internal

Dear Carlton

Thanks again to you, Richard and Jason for coming across to the Compass Centre on Monday morning to discuss the ORC protocol. I felt it was a useful conversation and I appreciate you also summarising your thoughts coming out of the meeting from your perspective.

As discussed on Monday, our position is that the independent review is the key opportunity to address your questions relating to fixed costs and we don't believe its scope is constrained by the ORC Protocol, but rather the terms of reference which the CAA is setting following consultation with users and Heathrow.

As stated during the session on Monday, we consider the independent review is the key opportunity to address open questions relating to fixed costs. These costs, via their inclusion in table 8.2, were determined by the CAA (albeit based upon numbers provided by Heathrow) to represent non-airline fixed costs, form part of the H7 decision and without the referenced adjustment mechanism in the airport charges price control mechanism, have essentially been fixed. We were disappointed to learn that this has not been acknowledged by the CAA in their interaction with you.

I was surprised to hear your view that different governance arrangements to those offered to airlines is something you would be open to. Our reading of the CAA's guidance is that governance arrangements should be consistent across all users and we do not believe that a two-tier ORC process is desirable.

On the point of the inflation of fixed costs, for the record, I note that we discussed that there is the application of inflation on fixed costs as that is consistent with the treatment of these costs on the RAB and the ORC principle was that all associated costs should be recovered via ORCs.

We are picking up your points about the fixed asset register with our finance team as well as preparing our response to the CAA independent review draft terms of reference.

I look forward to continuing the conversation and would propose a follow up discussion on at 14:00 on 22nd November at the Compass Centre. I anticipate that we will have shared a full set of formal consultation documents in good time ahead of this. I have just sent an invitation for this time, but happy to explore alternative opportunities if not convenient.

Best wishes

Calum

From: [REDACTED]

Sent: 06 November 2023 18:11

To: [REDACTED]

Cc: [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

Subject: Key themes from the non-airline ORC user protocol meeting

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Dear Calum

Many thanks for setting up and hosting the meeting today which I thought was helpful in raising a few issues in connection with your draft ORC protocol. Whilst we did not discuss the detail of the draft documents, rather we discussed the concept of the proposed process, I thought it would be helpful to summarise some of the key themes:

- HAL sees the protocol document as dealing with future changes in cost, however, we considered that it should cover the entire ORC cost being charged ie including the brought forward annuity / fixed costs.
- HAL considers the historical annuity / fixed costs as a closed issue as the CAA has determined them, however, we consider:
 - a) the CAA said that HAL should charge the (ORC) users the actual costs incurred, but it was up to HAL to determine what these are and demonstrate their reasonableness to users
 - b) the CAA has not said in any of its correspondence that it has determined fixed costs for ORCs
 - c) in any event the CAA did not know what the fixed costs were to be able to determine them (as they are a HAL derived number)You explained that this was not HAL's reading of the determination, but that you would take this away to review.
- There was a general discussion on cost inflation and we considered that ORC users should not be charged for inflation as this was not an actual cost. I know that this has been raised before in the wider ORC meetings and James Cornelius had taken this away to consider.
- In relation to transparency you asked what further information we were looking for; I said that we wanted the actual historical cost of fixed assets, whenever that was (I mentioned for instance even if it goes back to 1955) reconciled into the RAB and demonstrated how that agrees into the stated annuity / fixed costs that non-airlines users are being charged.
- I said I would not sign up to a confidentiality agreement as that fundamentally conflicts with transparency and furthermore I couldn't envisage anything that had been requested would be commercially sensitive information. However, if there was something that was demonstrated to be confidential, then this could be dealt with separately by exception.
- Finally we discussed about potentially having a different protocol between airlines and non-airlines and whether this was something we would wish to consider. We agreed that we would want to consider this.

I hope this is a fair summary, but just wanted to ensure I captured our key thoughts. I look forward to our next session.

Kind regards

Carlton

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